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Tax Topics

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Due to fewer and less important updates, our weekly COVID coverage now follows our feature article.

TAX PLANNING FOR THE NON-SPECIALIST ADVISORUNLOCKING LIQUIDITY IN CORPORATE CAPITAL LOSSES—PLANNING TO MAXIMIZE THE CAPITAL DIVIDEND ACCOUNT—PART III

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Recently, I published a short note on LinkedIn[1] with a list of some recessionary planning tools and strategies that advisors may wish to consider using to assist their clients in these difficult times. In that short note I also mentioned I was hoping to write about some of those ideas. This three-part series[2] (the "Series") is part of my effort at following through on my good intentions.[3]

In particular, the Series has been designed to encourage advisors to strategically plan corporate loss transactions to enable their clients to maximize the tax-free benefits of the Capital Dividend Account ("CDA").[4] As the Series progresses the discussion will progress from a review of the most basic principles to more advanced planning concepts. Part I of the Series reviewed gain and loss taxation at its most basic, and it also reviewed certain key aspects of the CDA relevant to the Series theme, including what I refer to as Strategic CDA Planning. Part II of the series fleshed out a number of other relevant CDA matters and introduced what I refer to as a 4C Strategy. Finally, this Part III of the Series will review some strategies to enhance Strategic CDA Planning and also discuss a few cautions.

ENHANCED STRATEGIC CDA PLANNING—ASSET SECURITIZATION, WASTING AN ESTATE FREEZE, ETC.

To this point the Series has demonstrated how to use capital losses (tax lemons) strategically to create tax free liquidity for shareholders (tax lemonade). The reality is that the recipe of each client's tax lemonade will differ and the planning for clients can create all sorts of ancillary benefits.

As an example, if Mr. Wise[5] didn't need all of the cash from CDA Dividends for personal use he might choose to lend some or all of the funds back to the corporate group on a secured basis. Better protecting assets is planning that can be beneficial in any time period, let alone during a recession.

If Mr. Wise's interests in Holdco included low adjusted cost base ("ACB") and low paid-up capital ("PUC") fixed value preferred shares, CDA distributions could be made on a deemed basis by redeeming Mr. Wise's shares and having Holdco elect to treat the deemed dividends on redemption[6] as CDA Dividends.[7] Assuming that Mr. Wise does not own common shares,[8] this type of planning would reduce Mr. Wise's exposure to tax on death.[9] In this case, assuming that the entire $500,000 CDA balance is used to redeem $500,000 of Mr. Wise's preferred shares of Holdco, his tax exposure on death would be reduced by more than $125,000,[10] further enhancing the benefits of the planning.

With a bit of creativity, these and other plans could be implemented to further enhance Strategic CDA Planning for clients.

ENHANCED STRATEGIC CDA PLANNING—CHARITABLE GIVING

In recessionary times the needs of our communities are greater than ever. However, as a result of recessionary pressures on clients other priorities may interfere with charitable giving objectives.

For some clients, combining charitable giving with Strategic CDA Planning, including, where appropriate, a 4C Strategy, may provide them with incentives to be charitable or to continue with their charitable giving.

Assume that the 4C Strategy implemented above for Mr. Wise and his corporate group is adjusted so that Holdco only crystallizes $800,000 of capital gains and gifts $200,000 of Opco shares to a registered charity.[11]

Many of the tax results described in the 4C Strategy for Mr. Wise and his corporate group in Part II of the Series would apply. Notably, Mr. Wise could enjoy $500,000 of tax-free cash on the redemption of his shares out of the CDA and would reduce his future tax liability exposure on death as previously described.

While Holdco would be able to use its capital losses to pay no tax in both scenarios, the addition of the gifting strategy would give rise to a few different tax results in Holdco than a straightforward 4C Strategy. In particular, Holdco would ultimately be entitled to a $200,000 deduction against any income earned by it.[12] Also while Holdco would still have $1,000,000 of ACB in *securities* issued by Opco, it would now own shares of Opco with $800,000 of ACB and it would also hold $200,000 in secured debt of Opco instead of owning shares of Opco with $1,000,000 of ACB.

This planning alone may be enough to encourage Mr. Wise to cause Holdco to make the donation. Alternatively, if Mr. Wise decides that he values personal tax-free cash and additional ACB in Holdco's shares of Opco more than he values a deduction from taxable income in Holdco,[13] then in advance of realizing capital losses, Holdco might use up its charitable deduction by crystallizing $400,000 of additional unrealized capital gains on its Opco shares.[14] The crystallization would create additional ACB of $400,000 in Holdco's shares of Opco and it would generate an additional $200,000 of CDA. This CDA would allow Mr. Wise to redeem an additional $200,000 of his Holdco preferred shares on a tax-free basis, which would further reduce his future tax liability obligations on death.

The chart below *attempts* to summarize the benefits of adding in donation and additional crystallization planning to the 4C Strategy discussed in the immediately preceding section.

	Donation, Extra Crystallization, and 4C Strategy	**4C No Donation**	**Difference**
Donation	$200,000	None	$200,000
Holdco Tax	None	None	None
Holdco non-capital loss carryforward	None	None	None
Holdco Deduction (75% limit + 25% CG from donation)	Used	None	None
CDA	$700,000	$500,000	$200,000
Cash to Mr. Wise	$700,000	$500,000	$200,000
Tax to Mr. Wise	None	None	None
Reduction in capital gain on death tax to Mr. Wise	$700,000	$500,000	$200,000
Cost of Opco shares owned by Holdco	$700,000	$500,000	$200,000
Note owing to Holdco to fund Opco share redemption	$200,000	None	$200,000
Change in Value of Opco Equity	($200,00)	None	($200,000)

This is just one illustration of how combining traditional strategies such as a wasting freeze and charitable giving with a Strategic CDA Plan, in this case a 4C Strategy, could enhance charitable giving benefits for charitably inclined clients. However, there are endless variations of planning combinations that a creative planner could come up with.[15]

STRATEGIC CDA PLANNING—SOME CAUTIONS

The Department of Finance ("Finance") and the CRA generally consider a surplus strip to be any planning that is intended to allow distributions of corporate property to be made to individual shareholders at a reduced tax rate when compared to distributions made by way of taxable dividends. These government bodies are generally of the view that corporate distributions should be taxed as dividends.[16]

Based on the perspective of these government bodies, it appears that they may consider the 4C Strategy and maybe even Strategic CDA Planning generally to be forms of surplus strips. This view appears to be reinforced by the introduction on July 18, 2017 of retroactive legislation that, as initially drafted, would have made the 4C Strategy and Strategic CDA Planning generally, as well as many other types of common tax planning strategies, ineffective.

Fortunately, much of the July 2017 draft legislation was abandoned, including the anti-surplus stripping provisions. In addition, some comfort can be taken from previous CRA commentary that has generally indicated that the CRA would not challenge corporate surplus strips because it was unlikely that assessments under the general anti-avoidance rule (GAAR)[17] would be successful.[18]

Still, it is believed that Finance continues to study surplus stripping and continues to view most forms of surplus strip planning to be offensive. Also, in the face of ever-growing federal debt it cannot be assumed that Finance will not try to eliminate the benefits of this type of planning in the future. As a result, Strategic CDA Planning strategies should not be regarded as completely risk free.

Even ignoring tax risks of the type noted above, as was discussed previously, Strategic CDA Planning can result in blockages in the ability to pay future CDA Dividends.

Although the 4C Strategy will increase the ACB in corporate shareholdings such as Holdco's interests in Opco, the 4C Strategy does not increase the underlying ACB of the assets in a corporation such as Opco. This may or may not be a concern depending on the tax characteristics of the assets in Opco and the likelihood that in the future an exit from Opco will be through an asset sale as opposed to a share sale. The planning point raised by this issue is that before implementing a 4C Strategy, it will be worth considering whether the strategy could lead to double taxation if there is a future sale of the Opco assets instead of a sale of the high ACB Opco shares.

Clients considering implementing Strategic CDA Planning (or related 4C Strategies) should be aware of all of the issues and risks associated with these types of plans.[19] Nonetheless, I believe that, taking into consideration the benefits of Strategic CDA Planning (including 4C Strategies) and the current recessionary situation, and assuming a client needs or desires personal liquidity, the benefits will, in many cases, far outweigh any issues and risks associated with the planning.

LOBLAW FINANCIAL: THE "SEINFELD" OF LEAVE APPLICATIONS

- –Steve Suarez, Borden Ladner Gervais (Toronto)

-What's the show about?

It's about nothing.

-It's about nothing?

Absolutely nothing. Everybody's doing something; we'll do nothing.

-So we go into NBC, we tell them we've got an idea for a show about nothing.

Exactly.

-They say "what's your show about?" and I say "nothing."

There you go.

-I think you may have something here . . .

—*Seinfeld*, Season 4, Episode 43 ("The Pitch")

A civil litigant hoping to have its appeal heard by the Supreme Court of Canada ("SCC") faces a daunting challenge. Of the approximately 600 leave applications submitted each year, only about 80 are granted.[20] The SCC will grant leave only if there is an issue of public importance or of such a nature or significance as to warrant a decision by the Court that transcends the interests of the immediate parties, described on the SCC website as (for example) something "likely to have an impact on society as a whole". The bar for obtaining leave from the SCC to appeal is very high indeed.

The Crown is seeking leave to appeal the decision of the Federal Court of Appeal ("FCA") in *Loblaw Financial Holdings Inc. v. The Queen*,[21] which overturned the Tax Court of Canada's decision in favour of the CRA. While both the facts and the relevant legislative regime are complex,[22] in brief the case deals with whether or not a foreign subsidiary of the Canadian taxpayer earned the type of income ("foreign affiliate property income" or "FAPI") that is imputed back to and taxed in the hands of its Canadian shareholders even when not actually distributed to them. The FCA concluded that the foreign subsidiary had not earned FAPI, holding that "the Tax Court's conclusion on the arm's length issue is built on an interpretation of the applicable legislation which significantly overreaches and contains errors of law" (para. 51).

In seeking leave to appeal from the FCA's decision, the Crown is attempting to meet the "issue of public importance" standard by trying to frame the issue to be decided as the proper interpretation of the FAPI regime generally.[23] This in fact is not the case. Rather, the issue before the Court is the correct interpretation of one phrase[24] within one paragraph of the definition of one term[25] relevant to one of the various items[26] included in FAPI, which paragraph sets out an exception applicable to a small number of businesses (made even smaller by a 2014 legislative amendment). It will be very hard indeed for the Crown to convince the SCC that the interpretation of that phrase rises to the level of being an issue of public importance, particularly when the government reviewed the paragraph in question in 2014 and actually amended the *Income Tax Act* (Canada) ("ITA") to narrow the scope of the exception at issue but left the relevant phrase in question unchanged, despite having already audited Loblaw Financial and others on this issue.

If the government was aware in 2014 that taxpayers were deploying billions of dollars—representing over $1 billion in taxes allegedly owing—based on an interpretation of the relevant phrase different than the government's (and, to quote the Crown's leave application, in such a manner as to "result [in] an absurdity"),[27] but nonetheless concluded that the correct interpretation of that phrase was not important enough to change or clarify it, Crown counsel faces a steep uphill battle to convince the SCC that the same issue is today an issue of public importance warranting the Court's consideration (and possible correction). Essentially, the Crown is asking the SCC to judicially rewrite the same phrase that the government itself consciously chose not to revise when the legislation was reconsidered and amended in 2014 despite knowing there was an issue with it.

THE ISSUE

Canadian taxpayers are subject to tax under the ITA on income earned in or outside of Canada. If a Canadian taxpayer creates a foreign corporation that it controls (a "controlled foreign affiliate" or "CFA"), that CFA is itself taxable in Canada only on Canadian-source income. The FAPI rules in the ITA address this fact pattern, by attributing back to the Canadian shareholder of the CFA certain types of income (collectively, FAPI) earned by that CFA, even if not actually distributed back to the Canadian shareholder. Any FAPI earned by a CFA is imputed back to and taxed in the hands of its Canadian shareholders; conversely, non-FAPI is not.

The rules for determining what is and is not included in FAPI are extremely detailed and (to quote the FCA) "notoriously complex", but are helpfully summarized at a high level by two leading international tax lawyers as follows:[28]

> All income of a foreign affiliate is included in one of four mutually exclusive categories: (1) income from an active business, (2) income from property, (3) income from a business other than an active business, and (4) income from a "non-qualifying business." The first category, income from an active business, is not included [in] FAPI. The last three categories of income are included in FAPI.

The appeal at hand involves the second category of income: income from property. More specifically, the issue deals with the interpretation of one phrase within one paragraph of one defined term ("investment business"), which defined term sets out the scope of one of the types of income (income from an "investment business") deemed to be included within "income from property" and hence within FAPI. Specifically, paragraph (*a*) of the "investment business" definition creates an exception (the "Exception") to "investment business" characterization of certain activities that would otherwise be considered an "investment business". Where applicable, the Exception deems those activities not to be an "investment business", such that the income earned by a CFA of a Canadian taxpayer from those excepted activities will *not* be income from an "investment business" and so *not* FAPI.

The Exception is limited to a discrete list of regulated financial services businesses (e.g., banking, insurance, trading/dealing in securities or commodities), real estate development, moneylending, and leasing/licensing property (collectively, "Carved-out Businesses"). One of the conditions (the "Arm's Length Condition") for the Exception is that a taxpayer's CFA not conduct the Carved-out Business principally with non-arm's length persons.

The government reviewed the scope of the Exception in 2014 and enacted a legislative amendment (subsection 95(2.11)). That amendment further narrowed the already-narrow scope of Carved-out Businesses, but didn't revise or clarify the Arm's Length Condition, despite the fact that by that time the government was already auditing Loblaw Financial (and apparently other taxpayers) on this specific issue and so was aware of the interpretational dispute and the amounts at stake.

In summary then, the Crown is seeking to convince the SCC to rule on the correct interpretation of the Arm's Length Condition within the Exception to the "investment business" definition (being one of the components of "income from property" that is in turn one of the components of FAPI):

- that exists only for Carved-out Businesses; and
- which the government chose not to clarify in 2014 when it reviewed and narrowed the scope of the Exception.[29]

Can Crown counsel sell this to the SCC as an issue of public importance? Even an experienced observer could be forgiven for visualizing George Mallory and Andrew Irvine at Mt. Everest base camp *circa* 1924 staring upwards. Indeed, it is perhaps not a coincidence that the litigant taking on such a daunting challenge enjoys the advantage of literally being able to print its own currency in limitless amounts to fund its expenses.

Apparently undeterred by having so little to work with, Crown counsel gamely takes on this challenge in its leave application. But how to whip up the flames of judicial indignation with so little kindling available? With a whole lot of huffing, puffing, and puffery …

"DID ANYBODY CALL HERE ASKING FOR VANDELAY INDUSTRIES?"

The FCA's judgment contains the following statements about the FAPI regime cited by the Crown in its leave application:

- [19] "The FAPI scheme is intended to prevent Canadians from avoiding tax on passive income by earning such income in foreign corporations located in low-tax jurisdictions";
- [48] "Turning to the purpose of the provision at issue, the arm's length test is one of several requirements to qualify for one of the exclusions. The exclusions generally further the fundamental purpose of the FAPI scheme, which is to apply only to passive income";
- [73] "… The FAPI regime as a whole, and the foreign bank exclusion in particular, is intended to encourage Canadians to carry on active businesses outside Canada …"

The FCA's judgment also contains a number of other statements about the FAPI regime *not* cited by the Crown in its leave application [emphasis added]:

> [21] At a very basic level, the FAPI scheme operates by distinguishing between active business income, which is not FAPI, and passive income, which is. As described in the Tax Court's reasons, after the FAPI legislation had been in force for several years the government was concerned that the legislation did not have sufficient teeth to achieve its purpose. The problem was perceived to be that there were no legislative definitions of "active business income" or "passive income". Accordingly, in 1995 the legislation was overhauled to provide detailed definitions, including a definition of "investment business" which in general terms represents passive income.
>
> …
>
> [46] As for context, at a high level the FAPI scheme differentiates between passive income and active business income. As described in detail by the Tax Court, legislative changes were made to the scheme in 1995 in response to concerns that the existing legislation did not have sufficient teeth to properly capture passive income. One way in which this objective was addressed was to add a definition of "investment business".
>
> [47] The definition of "investment business" differentiates between active business income and passive income in a very rough way. It does this by encompassing a wide range of businesses and providing for a limited number of specific exclusions.

In its leave application, the Crown characterizes the first three excerpts from the FCA judgment as constituting (1) a "flawed understanding of the purpose of the FAPI rules" (para. 41), and (2) a "transformation of [the FAPI] anti-avoidance regime, which targets the use of foreign subsidiaries as a means to avoid Canadian tax, into an incentive to carry out proprietary investments abroad" and "an affront to Canadian taxpayers and undermines Canada's ability to protect its tax base" (para. 39). The Crown also claims that the FCA "treated the financial institution exception as a broad tax incentive, rather than as the narrow exemption to the investment business anti-avoidance rule that it is" (para. 5).

The leave application goes on as follows (paras. 46-47):

> The FCA's findings as to the purpose of the FAPI provisions limit their application to what the FCA describes as "passive income", which disregards their broader anti-avoidance function. In doing so, the FCA disregards the broader anti-avoidance function of the FAPI regime, which is to prevent the avoidance of tax from profits on highly-mobile investments, regardless of whether they would otherwise be viewed as "passive income". This is a fundamental error, the effects of which could reach far beyond the financial institution exemption, as described above.
>
> The "active – passive dichotomy" is an anachronism, harkening back to the period before the 1995 overhaul of the FAPI rules. The 1995 amendments to the *Act*—which included defining "investment business", "active business", "income from an active business" and "income from property"—were Parliament's reaction to perceived abuses of the existing rules, and Court decisions which set too low a bar with respect to the amount of activity required to distinguish between active and passive income. This low threshold was inconsistent with the goal of the FAPI regime, which is to prevent tax avoidance and the resultant erosion of the tax base caused by Canadians parking investments in offshore companies located in low tax jurisdictions.

When the relevant portions of the FCA's judgment are viewed in their entirety rather than cherry-picked for effect, there is no reasonable doubt that the Court clearly understands the purpose of the FAPI regime and its anti-avoidance rationale. The use of the labels "passive" and "active" as rough, high-level markers of what (in general terms) is and is not included in FAPI is both common in the tax community and largely accurate. There is nothing in the FCA's judgment indicating that the use of the term "passive" as a label to describe income from an investment business had any substantive impact on the Court's interpretation of the Arm's Length Condition specifically or the provisions of the FAPI regime generally, and indeed the Crown's leave application does not identify such.

Characterizing the FAPI regime as (1) an anti-avoidance regime for offshore passive income, or (2) an incentive (via non-application) for offshore active business income is simply two sides of the same coin, again without substantive relevance. The FCA was also clearly well-aware that the 1995 amendments to the FAPI rules expanded the scope of FAPI and caused "profits on highly-mobile capital earned by a foreign affiliate in a businesslike manner"[30] to be FAPI (subject of course to the Exception). There is simply nothing to the core component of the Crown's assertion that the FCA didn't understand the FAPI rules or their purpose, and that therefore an issue of public importance exists.

"AND I HAVE HORSES TOO: SNOOPY AND PRICKLY PETE"

The Crown's leave application claims that its concerns have been "echoed in commentary from the tax community" (paras. 52 – 54), seeking to create an image of hue and cry. In this regard the Crown cites an article[31] by Professor Brian Arnold (a well-known and highly regarded tax lawyer) pre-dating the Crown's leave application and from which the latter appears to draw extensively. One portion of Professor Arnold's article not cited in the Crown's leave application is the following:

> At the outset, it should be recognized that the definition of an "investment business" in subsection 95(1) is seriously flawed from both a drafting and policy perspective. It is awkward to have one of the major conditions for the exclusion—the condition at issue in this case—presented as a parenthetical expression. The 5 full-time employee condition is ridiculous with respect to large multinational corporations and the "licensed and regulated" condition is a meaningless formality that will be met in every situation.
>
> Given these flaws, one possible approach to this case is for a court (and also for the CRA and Justice) to take the position that the government should bear the burden for the flaws since it drafted the rules, and taxpayers should be able to take advantage of the flaws. This approach puts the responsibility for the effectiveness of the legislation exclusively on the Department of Finance and the government. I have some sympathy with this approach, especially with respect to the 5 full-time employee condition, where the flaws are so clear they cannot possibly be considered unintentional.

Professor Arnold believes the FCA should have instead taken "a more purposive interpretative approach" and invoked the interpretive principle against absurdity, on the basis that "it would be absurd to interpret the exclusion for foreign banks to allow a foreign bank to take advantage of the [Exception] when all the bank does is take capital from its Canadian parent company and invest it principally in passive investments." He further:

- agrees that on a textual interpretation "the 'principal business' exception refers to a 'business', and it is well established that, for purposes of computing the income of a business, the source of the equity capital of the business [i.e., as coming from its shareholder] is irrelevant";
- describes the FCA's choice of authority for taking a "formalistic institutional approach" to interpreting the business of banking as "puzzling," not applicable to other Carved-out Businesses, and inappropriate in a FAPI context;
- expresses the view that the 2014 amendment to the Exception "does not go far enough" and that the Exception should be further legislatively amended;
- queries why the Crown chose not to pursue GAAR on appeal to the FCA; and
- concludes by stating that "[I]n summary, although the Court's decision is defensible on the basis of a narrow literal interpretation of the [Arm's Length Condition] of the [Exception], I don't find the Court's reasoning to be convincing."

Thus, only some of Professor Arnold's points favour the Crown's case, his concerns are essentially ones of tax policy to some extent, and on the facts at hand the taxpayer would certainly dispute that "all [its CFA did] is take capital from its Canadian parent company and invest it principally in passive investments." Ultimately, these are all issues which the Crown had its chance to argue before the FCA from the advantageous position of being the respondent on appeal, and it was unsuccessful. However badly the CRA would like a do-over on them, that is not the role of the SCC nor the standard for obtaining leave to appeal, and there is no groundswell of support for the Crown's position within the tax community.

The only other "echo" from the tax community identified by the Crown is a news story reporting on the decision in "The Canadian Accountant, an independent news source for the accounting profession". The Crown states that this story references "tax fairness advocates (Spokespersons for Canadians for Tax Fairness, and the Canadian Taxpayers' Federation) who decry the decision." Not mentioned is the fact that the primary complaint of the "tax fairness advocates" referenced is that "the federal government is not serious about offshore tax avoidance and evasion and that corporate tax law was 'too loose' in Canada", and that existing tax laws should be rewritten to expand the scope of what is taxed in Canada, i.e., a legislative/ tax policy complaint, rather than a complaint that the case at hand was wrongly decided on the law.[32]

A further paragraph in the leave application[33] references "public concern over the consequences of the FCA decision" being expressed by "newspapers such as the National Post and the Chronicle Herald over the lack of adequate measures for the taxation of corporations that avoid taxation in Canada by taking their money offshore." This is in fact a single story appearing in both papers (both owned by Postmedia) quoting the same two "tax fairness advocates" referenced in The Canadian Accountant article (which links to the National Post article); the newspapers themselves express no such concerns, contrary to what the leave application states. Thus, apart from Professor Arnold's article, the complaints with the FCA's decision cited by the Crown amount to the same two "tax fairness advocates" reproduced in two separate articles, one of which is reproduced in two jointly-owned publications and the other of which links to the first one, and which in any event are largely directed at international tax policy rather than the specifics of this case. The attempt at contriving "public concern" falls flat, and in so doing damages the Crown's credibility.

"I'M DR. VAN NOSTRAND FROM THE CLINIC"

The Crown's leave application asserts that "the FCA's literal reading of the arm's length test leads to the absurd interpretation that the exclusion applies to banks that only take capital from related entities and invest it for their own account principally in highly liquid low risk investments." This is neither what Loblaw Financial's CFA in fact did (for example, most of its funds came from retained earnings generated outside of Canada) nor a result that (even if true) is either absurd or contrary to the FAPI regime as a whole.

Income earned by a CFA from a particular activity either is or isn't FAPI. Where the line between the two should be drawn is a tax policy judgment on which reasonable people can legitimately disagree and on which the government has the last word as the drafter of legislation. The government consciously chose to create an exception for Carved-out Businesses meeting various conditions to the general rule on what constitutes an "investment business", the scope of which was before the Court in *Loblaw Financial*. The rationale for the tax policy choices Parliament made in drawing that line where it did is not before the SCC, and in any event those choices are Parliament's alone to make. Indeed, the same commentator cited by the Crown throughout its leave application (Professor Arnold) observes that "the definition of an 'investment business' in subsection 95(1) is seriously flawed from both a drafting and policy perspective." How then can the courts be expected to "correct" serious flaws in tax policy, particularly when Parliament itself as recently as 2014 revisited and revised the relevant provisions? A result would have to be very "absurd" indeed to justify the sort of judicial re-write the Crown is seeking, and the subject matter of this case is nowhere near that.[34]

"I TELL YOU JERRY, AT THAT MOMENT I WAS A MARINE BIOLOGIST"

As noted, the government reviewed and amended the scope of the Exception in 2014, by which time it had long been aware of the fact that many taxpayers believed the Arm's Length Condition meant something quite different than the government's interpretation. Notwithstanding such awareness, the government left the Arm's Length Condition unchanged, and introduced a different tax policy change in subsection 95(2.11) to limit the scope of the Arm's Length Exception to a narrower range of Canadian taxpayers rather than a narrower range of CFA business activities. Moreover, this legislative change was made on a purely prospective basis.

Before the FCA, the Crown advanced the position that the taxpayer's interpretation of the Arm's Length Condition would produce an outcome contrary to the purpose of the FAPI regime. To this the Court responded as follows:

> [86] Finally, the Crown submits that if Loblaw Financial's position is accepted, the very target of the FAPI legislation, which is an investment portfolio held offshore, would be exempt. The concern is a valid one, but it does not enable a court to give the legislation a broader interpretation than it can reasonably bear. A gap in the legislation is for Parliament to address. It appears that Parliament may have now done so with the addition of subsection 95(2.11) of the ITA, but this is not relevant for purposes of this appeal.

With remarkable *chutzpah*, the Crown characterizes the FCA's reference to the "gap in the legislation" advanced by the CRA as the subject matter of the 2014 amendment (which was irrelevant to the parties in *Loblaw Financial* and to the Court) instead of the interpretation of the Arm's Length Condition that was in fact before the Court. One cannot help but wonder how the Crown will be able to explain the statement in its leave application that "in introducing the [2014] enactment, Parliament did not foresee that the Courts would fail to give effect to the original purpose of the arm's length test," despite the fact that by that time the government was already re-assessing taxpayers (including Loblaw Financial) on the interpretation of the Arm's Length Condition.

"I'M H.E. PENNYPACKER; I'M A WEALTHY INDUSTRIALIST, PHILANTHROPIST, BICYCLIST …"

At the bottom of the barrel of the Crown's leave application is the assertion that the FCA's judgment "is at odds with the FCA's other recent decision in respect of the FAPI regime, *Barejo Holdings*, that decided the narrow issue of whether a financial instrument qualified as debt for the purposes of s. 94.1 of the *Act*" (para. 48). In *Barejo* the Court made a passing reference *in obiter* that "The fundamental objective behind both the FAPI regime and the OIFP rules is capital export neutrality, i.e., taxing capital appreciation in a similar way whether it results from Canadian or foreign investments."[35] The Crown does not explain how this description of the FAPI regime's purpose is incompatible with the anti-avoidance rationale expressed by the FCA in *Loblaw Financial*.[36] In any event, since the FAPI regime was not before the FCA in *Barejo* (as the Crown acknowledges), even if it was somehow incompatible in no plausible way does *Barejo* constitute a "conflicting decision" requiring the SCC's intervention.

"A DONATION IN YOUR NAME HAS BEEN MADE TO THE HUMAN FUND"

Convincing the SCC to grant leave to appeal is difficult, and Crown counsel in this case simply don't have much to work with in terms of finding an "issue of public importance". The reality is that the Crown had the opportunity to make its case before the FCA as to the purpose and interpretation of (1) the Arm's Length Condition for the Exception to the Investment Business definition that exists only for Carved-out Businesses specifically, and (2) the FAPI regime generally. Having failed, the CRA would now like a do-over on the same issues before the SCC. This is not the role of Canada's highest court, and it seems doubtful that the SCC will grant leave. Should the Crown believe the FAPI provisions are being incorrectly applied by the courts, it has the options of amending the law (as it could have done in 2014) or taking another case through the courts. For this taxpayer however, enough should be enough.

COVID-19 UPDATE

Given the rapidly changing information related to COVID-19 we are providing continuously updated information at https://blog.intelliconnect.ca/.

PROVINCIAL

British Columbia

HELPING FARMERS RETAIN PROPERTY TAX STATUS (JULY 29, 2020)

In order to be classified as a farm in British Columbia, properties must meet certain criteria, including generating a minimum amount of gross income from a qualifying agriculture use based on the size of the parcel of land. This minimum income requirement must be met every two years and there must be some income generated every year. BC Assessment sends out self-reporting income questionnaires and conducts intermittent inspections to determine whether a property should maintain its farm status for the upcoming tax year.

However, the Government of British Columbia is waiving minimum income requirements for existing BC farm operations, allowing them to maintain their current property tax farm status for 2021.

Manitoba

WORKERS TO RECEIVE RISK-RECOGNITION PAYMENTS (JULY 29, 2020)

The province is issuing payments to 78,442 Manitobans as part of the $120-million Risk Recognition Program to acknowledge front-line workers during the COVID-19 pandemic.

The province will divide $120 million equally among all eligible recipients for a payment of $1,530. As the payments are considered taxable income under federal tax rules, the province has remitted a 10 per cent withholding tax to the CRA to help recipients when they file their 2020 income tax return. Eligible recipients will be notified via email of a $1,377 direct deposit in their bank account this week.

Eligible positions include health care, social services, justice, security, transportation, food and beverage, hotels, and essential retail. Payment recipients include 37,060 public-facing essential roles in retail services and lodging, 27,085 in health care, 9,325 in social services, and 3,440 in transportation. The province based the eligibility criteria on recommendations it received during extensive consultations with business and union representatives.

Northwest Territories

WAGE TOP-UP PROGRAM EXTENDED (JULY 28, 2020)

The government announced that it will extend the wage top-up program for an additional eight weeks to match the federal extension of the Canada Emergency Relief Benefit (“CERB”) to October 3, 2020.

Saskatchewan

TEMPORARY WAGE SUPPLEMENT PROGRAM EXPANDED (JULY 30, 2020)

Through a re-assessment of eligibility, the temporary wage supplement program has been further expanded to include all workers, regardless of income level, at integrated healthcare facilities which provide both short-term and long-term health care. A new application form is currently being developed for this expansion. Applications will be accepted until September 1, 2020.

Previously, workers at integrated facilities were eligible if they had a gross salary from all sources of less than $2,500 per month and earned less than $24.00 per hour. That income threshold has been lifted, as it was when the program was modified in June for workers at licensed personal care homes and special care homes.

INTERNATIONAL

IRS Warns US Tax Preparers To Use VPNs

The US Internal Revenue Service (“IRS”) has issued a statement urging tax practitioners to use a virtual private network (“VPN”) to protect taxpayers' data from cyber criminals.

A VPN provides a secure, encrypted tunnel to transmit data between a remote user and the company network via the Internet. As teleworking or working from home continues during the coronavirus, VPNs are critical to protecting and securing internet connections, the IRS said.

"For firms expanding telework options during this time, a virtual private network is a must have," said IRS Commissioner Chuck Rettig. "We continue to see tax pros fall victim to attacks every week. These networks are something you can't afford to go without. The risk is real. Taking steps now can protect your clients and protect your businesses."

The Department of Homeland Security's Cybersecurity and Infrastructure Security Agency (“CISA”) also encourages organizations to use VPNs. CISA also offers the following advice:

- Update VPNs, network infrastructure devices, and devices being used to remote into work environments with the latest software patches and security configurations;
- Alert employees to an expected increase in phishing attempts;

- Ensure information technology security personnel are prepared to ramp up the following remote access cybersecurity tasks: log review, attack detection, and incident response and recovery;
- Implement multi-factor authentication on all VPN connections to increase security. If multi-factor is not implemented, require teleworkers to use strong passwords; and
- Ensure IT security personnel test VPN limitations to prepare for mass usage and, if possible, implement modifications (such as rate limiting) to prioritize users that will require higher bandwidths.

Tax professionals also can get help with security recommendations by reviewing the recently revised IRS Publication 4557, ”Safeguarding Taxpayer Data”, and “Small Business Information Security: The Fundamentals”, by the National Institute of Standards and Technology.

INTERNATIONAL NEWS

IRS ADOPTS REGULATIONS ON SIMPLIFIED ACCOUNTING FOR SMALL FIRMS

On July 30, 2020, the United States Internal Revenue Service (“IRS”) issued proposed regulations to adopt the simplified tax accounting rules for small businesses under the Tax Cuts and Jobs Act (“TCJA”).

Prior to the TCJA, certain taxpayers could figure taxable income under the cash method of accounting if their average annual gross receipts for all prior taxable years did not exceed US$5 million. In the TCJA, provisions were added to the tax code to allow taxpayers to use the cash method if their average annual gross receipts for the three-taxable-year period ending immediately before the current taxable year were US$25 million (adjusted for inflation) or less. The new rules apply from tax years beginning in 2019 and 2020.

The TCJA also exempted taxpayers meeting the gross receipts test from the uniform capitalization rules. It also added an exception to the requirement to use an inventory method if their inventory is treated as non-incidental materials and supplies, or in accordance with the applicable financial statement (“AFS”). Taxpayers lacking an AFS are able to use their books and records.

The uniform capitalization rules require the capitalization of all direct costs and certain indirect costs allocable to real property and tangible personal property produced by the taxpayer.

The proposed regulations implement these statutory changes and provide clarifying definitions.

The proposed regulations also provide guidance for small businesses with long-term construction contracts and guidance on the requirements for exemption from the percentage-of-completion method and the uniform capitalization rules. For taxpayers with income from long-term contracts reported under the percentage-of-completion method, guidance is provided for applying the look-back method after repeal of the corporate alternative minimum tax and enactment of the base erosion and anti-abuse tax (“BEAT”).

AMAZON CONFIRMS PLANS TO PASS ON UK DIGITAL TAX TO SELLERS

Amazon has said that it will increase a range of seller fees in the UK following the government's introduction of a digital tax.

The two per cent digital services tax has applied since April 1 to the revenues of search engines, social media platforms, and online marketplaces that derive value from UK users.

An announcement on Amazon's portal for business users said that the tax "will impact fee rates on Amazon UK."

From September 1, 2020, Amazon will increase some fees by two per cent for items sold on Amazon UK "to reflect this additional cost." The move will affect Referral fees, Fulfilment by Amazon fees, monthly FBA Storage fees, and Multichannel Fulfilment fees.

Footnotes

[1] https://www.linkedin.com/posts/magoldberg_tax-planning-in-recessionary-times-michael-activity-6685984129349234688-sivQ

[2] Unless otherwise noted, defined terms in this article have the meaning designated in Part I of the Series.

[3] I have also co-written an article with Vincent Didkovsky "Refinancing Prescribed Rate Loans Used for Income Splitting", (August 2020) 10:3 *Canadian Tax Focus* (https://www.ctf.ca/ctfweb/EN/Newsletters/Canadian_Tax_Focus/2020/3/200302.aspx).

[4] I often refer to the process of taking *tax lemons* (for example, capital losses) and making them into something positive (for example, maximizing the benefits of the CDA) as making *tax lemonade*.

[5] The facts associated with Mr. Wise and his corporate group, including Holdco and Opco, were discussed in Parts I and II of the Series and examples in this Part III of the Series will build on those facts.

[6] See subsection 84(3) of the *Income Tax Act* (Canada) R.S.C. 1985 Ch .1 (5th Supp.), as amended (the "Act"). Unless otherwise noted all statutory references are to the Act.

[7] Through filings that would include the certified resolution in respect of the redemption, which should provide that deemed dividends arising from the redemption are CDA Dividends.

[8] Perhaps due to the prior implementation of an estate freeze (the details of estate freeze planning will not be reviewed in the Series).

[9] See subsection 70(5).

[10] This tax liability amount is approximate and is based on the assumption that Mr. Wise is a top rate Ontario taxpayer who, in the absence of the redemption, would have realized $500,000 of capital gains on the deemed disposition of Holdco preferred shares.

[11] Following the realization of capital losses on the liquidation of Holdco's portfolio of marketable securities, Holdco will lend some of the funds to Opco (on a secured basis) and Opco will use those funds to repurchase the gifted Opco shares.

[12] In general, paragraph 110.1(1)(a) limits the use of a corporation's charitable gift deduction in any particular year to 75% of the corporation's income in the year. However, where a corporation realizes capital gains in connection with a gift the limitation is increased by 25% of the taxable capital gains.

It is assumed that no limitations on the amount of the charitable gift will arise as a consequence of subsection 248(31) and associated provisions.

[13] A factor in this decision could be that, due to the recession, profits in Holdco will be suppressed for a long period of time making it difficult for Holdco to make use of the donation deduction.

[14] Depending on other income in Holdco, the taxable portion of the capital gains, being $200,000, may slightly exceed the total charitable gift deduction associated with the $200,000 donation of Opco shares. The difference is ignored in this illustration.

[15] Because the taxable portion of donated public company shares is nil and 100% of the capital gain from a donated public security is added to the CDA, corporate donation strategies involving public company shares with large unrealized capital gains will often be able to enhance the benefits of this type of combined strategy even more than using a gift of private shares.

[16] For example, see CRA document no. 2004-0086771C6.

[17] Section 245.

[18] See CRA document no. 2015-0610701C6. Also, recent jurisprudence including *Gwartz et al. v. The Queen*, 2013 DTC 1122 (TCC), has generally not agreed with the CRA's broad views on surplus stripping. Still, the CRA has had limited success attacking case specific surplus strip situations such as *MacDonald v. R.*, 2012 DTC 1145 (TCC) rev'd 2013 DTC 5091 (FCA).

[19] Other issues may also need to be considered, including the possible application of various stop-loss rules in the Act. For example, see the definition of "superficial loss" in section 54.

[20] https://www.scc-csc.ca/unrep-nonrep/app-dem/important-eng.aspx.

[21] 2020 DTC 5040 (FCA), reversing 2018 DTC 1128 (TCC).

[22] For a detailed discussion of the Tax Court's decision, see Suarez, "Loblaw Financial: Cleanup Needed in Aisle 4", Current Cases feature, (2019) 67:2 *Canadian Tax Journal* 363-67; and with

reference to the FCA's decision, Nathan Boidman and Michael Kandev, "Canadian Appeals Court Upholds Loblaw's Offshore Bank Structure", *Tax Notes Int'l*, July 27, 2020, p. 505.

[23] "Direction from this Court is needed to ensure the proper interpretation of the FAPI provisions." (Leave application para. 6.)

[24] "Any business conducted principally with persons with whom the affiliate does not deal at arm's length."

[25] "Investment business", subsection 95(1) of the ITA.

[26] "Income from property", subsection 95(1) of the ITA.

[27] Para. 5.

[28] Drew Morier and Raj Juneja, "Foreign Affiliates: An Updated Primer", in *Report of Proceedings of the Sixty-Fourth Conference*, 2012 Canadian Tax Foundation Conference Report (2013).

[29] For business reasons unconnected to the litigation, the Loblaw CFA to which this litigation relates was wound up in 2013, such that this issue ceased to be relevant to Loblaw after that time.

[30] Leave application, para. 48.

[31] "Why Does A Canadian Grocery Store Chain Need a Tax Haven Bank?" *The Arnold Report*, Posting 179, May 27, 2020, Canadian Tax Foundation.

[32] "Toby Sanger, director of Canadians for Tax Fairness, said the whole situation is a demonstration that the international tax system is fundamentally broken. 'I've been a bit frustrated that the Canadian government has simply said we're going to see what the outcome of this is, instead of pushing for reforms ourselves,' Sanger said." "Court of Appeal sides with Loblaw in $368 million tax case involving Barbados bank", *Financial Post*, April 26, 2020.

[33] Para. 54.

[34] For example, the Crown was unable to explain why it is that the Arm's Length Condition should be interpreted as implicitly requiring "competing" in respect of the receipt and use of funds (as the Tax Court did), when other provisions within the FAPI rules contain explicit language requiring such competition (subsection 95(2.4)). The FCA's judgment left no doubt as to where it stood on this point (at para. 58): "In addition, the Tax Court's focus on competition, which was dealt with at length in the Court's reasons, is an example of a court inferring a purposive interpretation from unexpressed legislative intent. … The emphasis in the Tax Court's reasons on an unexpressed intention of competition is not appropriate in this case which involves a FAPI scheme that is drafted with mind-numbing detail." And at para. 60: "As discussed in the Tax Court reasons, competition is recognized as a policy rationale for limiting FAPI to passive income and as such it would be relevant in a GAAR analysis. However, Parliament has not explicitly required competition as an element of the foreign bank exclusion at issue. This may be contrasted with other FAPI provisions where a competition requirement is explicit (see, for example, subsection 95(2.4) of the ITA)."

[35] 2020 DTC 5023 (FCA) (para. 86).

[36] "The FAPI scheme is intended to prevent Canadians from avoiding tax on passive income by earning such income in foreign corporations located in low-tax jurisdictions" (para. 19).